

Internal Revenue Service  
**memorandum**

CC:EE:4  
MJRoach

date: NOV 22 1991

to: Associate Chief, Milwaukee Appeals  
(Attn: Ron Vanderlinde, Appeals Officer) MW:MIL:AP

from: Assistant Chief Counsel  
(Employee Benefits and Exempt Organizations) CC:EE

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subject: [REDACTED] EIN [REDACTED]  
Control No. TR-45-1681-91

This memorandum is in response to your request made by telephone from Ron Vanderlinde to Michael Roach of this office for assistance concerning calculation of the limit on the amount allowable as a deduction for contributions made by taxpayer [REDACTED], to a voluntary employees' beneficiary association (VEBA) which it maintained during the taxable years ended [REDACTED], and [REDACTED]. The request also concerned the limit on the amount allowable to [REDACTED], a subsidiary of [REDACTED], for contributions to its VEBA. On [REDACTED], Mr. Vanderlinde transmitted to this office copies of the relevant portions of the Revenue Agent's Report, the Revenue Agent's response to the taxpayer's protest, and a memorandum prepared by Mr. Vanderlinde discussing the adjustments proposed by the Revenue Agent.

As we understand the facts, they are as follows:

On [REDACTED], [REDACTED] sponsored a VEBA that had assets set aside to provide benefits of the types described in section 419A(a) of the Internal Revenue Code. The VEBA keeps its books and files its federal income tax returns on Form 990 on a calendar year basis. On [REDACTED], the VEBA had a fund balance in the amount of \$[REDACTED]. During its taxable year ended [REDACTED], [REDACTED] contributed \$[REDACTED] to the VEBA. The entire amount of this contribution was made in [REDACTED]. There were no pre-contributions made to the VEBA during the period from [REDACTED], to [REDACTED].

The qualified direct cost of the [REDACTED] VEBA for the fund year ended [REDACTED], was \$[REDACTED]. In addition, the Revenue Agent determined that the qualified asset account limit of the VEBA on [REDACTED], was \$[REDACTED], based on the qualified direct cost of the VEBA for the prior year and the so-called "safe harbor" limits of section 419A(c)(5) of the Internal Revenue Code. The VEBA reported after tax income in the amount of \$[REDACTED] for the taxable year ended [REDACTED].

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██████. The Revenue Agent further determined that the existing excess reserve of the VEBA was \$██████, consisting of the remainder after subtracting the qualified asset account limit of \$██████ from the fund balance on ██████, in the amount of \$██████. The Revenue Agent multiplied the existing excess reserve by 60% to obtain the increase in the qualified asset account limit for existing excess reserves. The Appeals Officer corrected this percentage to 80%, based on the effective date of section 419 of the Internal Revenue Code, as interpreted by §1.419-1T Q&A 2 of the Treasury Regulations on Income Tax. The applicable qualified asset account limit, including the increase for existing excess reserves, as determined by the Appeals Officer, was \$██████.

The Revenue Agent deducted the fund balance on ██████, from the qualified asset account limit, leaving the fund with a negative qualified asset account balance, which the Revenue Agent then subtracted from the qualified direct cost for the year. Next, the agent subtracted the after tax income of the fund from the remaining qualified direct cost to determine what the agent considered to be the "Deductible qualified cost" of the fund. Finally, the agent added the balance in the fund on ██████ to the post-██████ contribution and deducted the qualified asset account limit to obtain a figure that the agent labeled "Nondeductible contributions". Since this figure exceeded the contributions made by ██████ during the taxable year, the agent concluded that the taxpayer was not entitled to any deduction in ██████. The Appeals Officer revised the agent's calculation to allow a deduction for the qualified direct cost for the taxable year, less the after tax income of the fund, not to exceed the amount contributed during the taxable year of the employer. This determination was based on the Appeals Officer's calculation showing that no addition to a qualified asset account was allowable in ██████ because the amount in the account at the end of the fund year on ██████ exceeded the applicable account limit. Using this method of calculation, the Appeals Officer allowed a deduction in the amount of \$██████ for the contributions made by ██████ to its VEBA.

████████████████████, a subsidiary of ████████████████████, maintained a VEBA with a fund year ending ████████████████████. During the fund year ended ████████████████████, the ████████████████████ VEBA had qualified direct costs of \$██████████████████. ████████████████████ contributed \$██████████████████ to the fund during its taxable year ended ████████████████████. All of the contributions made by ████████████████████ in its ████████████████████ fiscal year were made after ████████████████████.

The Revenue Agent determined that the deductible contribution to the ████████████████████ VEBA in FY ████████████████████ was limited to \$██████████████████, using a methodology essentially similar to the

methodology the agent had used in calculating the deduction limit for the [REDACTED] VEBA. The Appeals Officer recalculated the limit as he had recalculated the [REDACTED] limit, concluding that [REDACTED] was entitled to deduct qualified cost in the amount of \$ [REDACTED] in FY [REDACTED].

Section 419(a) of the Internal Revenue Code provides that contributions paid or accrued by an employer to a welfare benefit fund (e.g., a VEBA) shall not be deductible under chapter 1 of the Code but, if they would otherwise be deductible, they shall be deductible under section 419 in the taxable year when paid, subject to the limitation contained in section 419(b). Sections 419 and 419A are generally effective for contributions paid or accrued after December 31, 1985, in taxable years ending after that date.

Section 419(b) of the Code provides that the deduction allowable under section 419(a) shall not exceed the qualified cost of the welfare benefit fund for the taxable year.

Section 419(c) of the Code defines the qualified cost as equal to the sum of the qualified direct cost for the taxable year as defined under section 419(c)(3), plus the amount of any addition to a qualified asset account for the taxable year, subject to the limit contained in section 419A(b), less the after tax income of the welfare benefit fund for the taxable year.

Section 419A(a) of the Code defines the term "qualified asset account" as any account consisting of assets set aside to provide for the payment of disability benefits, medical benefits, SUB or severance pay benefits, or life insurance benefits.

Section 419A(b) of the Code states that no addition to a qualified asset account may be taken into account in determining the limit on the amount deductible under section 419(c) to the extent that the addition increases the amount in the account above the account limit described in section 419A(c).

Section 419A(c) of the Code sets the account limits applicable to each of the types of benefits listed in section 419A(a). In general, the account limit for each benefit is the amount reasonably and actuarially necessary to fund the claims incurred but unpaid at the close of the taxable year and the administrative costs associated with those claims. In addition, under section 419A(c)(2) of the Code, the account limit may include a reserve funded over the working lives of the covered employees and actuarially determined on a level basis to fund the amount necessary for the payment of post-retirement medical and life insurance benefits under the plan.

Section 419A(f)(7) of the Code increases the account limit for any of the first 4 taxable years to which section 419A

applies by the applicable percentage of any existing excess reserves. The applicable percentage is a declining percentage of the existing excess reserves which varies from 80 percent in the first year to which the section applies to 20 percent in the fourth year to which the section applies. The existing excess reserve is the excess, if any, of the amount of assets set aside for purposes specified in section 419A(a) at the close of the first taxable year of the fund ending after July 18, 1984, over the account limit (determined without regard to the adjustment prescribed by section 419A(f)(7)) for the taxable year for which the increase is being computed.

Section 1.419-1T Q&A 5(b)(1) of the Treasury Regulations on Income Tax provides that, notwithstanding any other provision of section 419 of the Internal Revenue Code or §1.419-1T of the Regulations, contributions to a welfare benefit fund during any taxable year of the employer beginning after December 31, 1985, shall not be deductible for the taxable year to the extent that those contributions increase the total amount in the fund as of the end of the fund year ending with or within the taxable year of the employer to an amount exceeding the account limit for that year. Solely for purposes of this paragraph, contributions paid to a welfare benefit fund during the taxable year of the employer, but after the end of the last taxable year of the fund that relates to the taxable year of the employer, shall be treated as amounts in the fund as of the end of the last taxable year of the fund that relates to the taxable year of the employer. Contributions that are not deductible under this paragraph are carried over to the next taxable year of the employer and are treated as contributed to the fund on the first day of the next taxable year of the employer.

Section 1.419-1T Q&A 9 of the Treasury Regulations provides that if the first taxable year of an employer ending after December 31, 1985, is a fiscal year, the employer's deduction for contributions to a welfare benefit fund in that year is limited to the greater of the following two amounts: (1) the contributions paid to the fund during the taxable year of the employer up to the qualified cost of the welfare benefit fund for the taxable year of the fund that relates to the taxable year of the employer, and (2) the contributions paid to the fund in the 1985 portion of the taxable year of the employer to the extent that those contributions were deductible under the rules governing the deduction of contributions to a welfare benefit fund prior to the effective date of section 419.

In the present case, the taxable years of [REDACTED] and [REDACTED] both ended on [REDACTED]. The year under examination for both companies is the year ended [REDACTED]. In that year, [REDACTED] contributed \$ [REDACTED] to its VEBA and [REDACTED] contributed \$ [REDACTED] to its VEBA. Both companies made their entire contributions after the

end of [REDACTED]. Accordingly, under §1.419-1T Q&A 9 of the Treasury Regulations, the entire amount of the contribution for fiscal [REDACTED] for both companies is subject to the qualified cost limitation of section 419 of the Code for the taxable year of the fund that is related to the taxable year of the employer (the fund year ended [REDACTED], in the case of [REDACTED], and the fund year ended [REDACTED], in the case of [REDACTED]). The taxable year of both employers began on [REDACTED], which is before December 31, 1985, so that the first taxable year to which §1.419-1T Q&A 5(b)(1) (the so-called "eat up" rule) applies, by its terms, is the taxable year beginning on [REDACTED], and the eat up rule is not applicable in determining the deduction limit for the taxable year involved in this examination. Section 419A(f)(7) of the Code, however, does apply to both employers in the taxable year ended [REDACTED], (the taxable year under examination) and that year is the first year to which section 419A(f)(7) of the Code applies, so that the applicable percentage under that section for the calculation of the increase in the qualified asset account limit for existing excess reserves is 80 percent.

The application of these principles of law to the deductions claimed by [REDACTED] and [REDACTED] for their VEBA contributions in their taxable years ended [REDACTED], is set forth in the table appended to this memorandum.

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MICHAEL A. THRASHER  
Assistant Chief Counsel

(signed) Mark I. Schwimmer

By:

MARK SCHWIMMER  
Chief, Branch 4  
Office of the Associate  
Chief Counsel  
(Employee Benefits and  
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[REDACTED] and [REDACTED]

WELFARE BENEFIT FUND DEDUCTION CALCULATIONS  
SECTION 419

	[REDACTED]	[REDACTED]
Deduction per return	\$ [REDACTED]	\$ [REDACTED]
Deduction per examination	[REDACTED]	[REDACTED]
Adjustment per examination	[REDACTED]	[REDACTED]
REVISED CALCULATIONS		
Qualified Direct Cost		
( [REDACTED] VEBA YE [REDACTED] )	[REDACTED]	[REDACTED]
( [REDACTED] VEBA YE [REDACTED] )		[REDACTED]
Qualified Asset Account Addition		
Fund balance at fund YE	[REDACTED]	[REDACTED]
Qualified asset account (QAA) limit		
IBU reserve (medical)	[REDACTED]	[REDACTED]
IBU reserve (disability)	[REDACTED]	[REDACTED]
QAA limit	[REDACTED]	[REDACTED]
Increase in QAA limit		
Reserve balance ( [REDACTED] )	[REDACTED]	
Reserve balance ( [REDACTED] )	[REDACTED]	
Less: QAA limit	[REDACTED]	[REDACTED]
Existing excess reserve	[REDACTED]	[REDACTED]
Multiplied by: 80% factor	[REDACTED]	[REDACTED]
Increase in limit	[REDACTED]	[REDACTED]
Add: QAA limit	[REDACTED]	[REDACTED]
Adjusted QAA limit	[REDACTED]	[REDACTED]
Qualified asset account addition		
(Adjusted QAA limit -		
Fund balance at fund YE)	[REDACTED]	[REDACTED]
Qualified Cost Calculation		
Qualified direct cost	[REDACTED]	[REDACTED]
Qualified asset account addition	[REDACTED]	[REDACTED]
Less: After tax income	[REDACTED]	[REDACTED]
Qualified cost (QC)	[REDACTED]	[REDACTED]

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Contributions (Employer YE  
[REDACTED])

[REDACTED]

[REDACTED]

Deduction allowable  
(Contributions NTE QC)

[REDACTED]

[REDACTED]

Corrected Adjustment Calculation

Deduction per return

[REDACTED]

[REDACTED]

Less: Deduction allowable

Corrected Adjustment

[REDACTED]

[REDACTED]